RESERVE BANK OF FIJI ECONOMIC FOCUS

`Types and Strains of Inflation

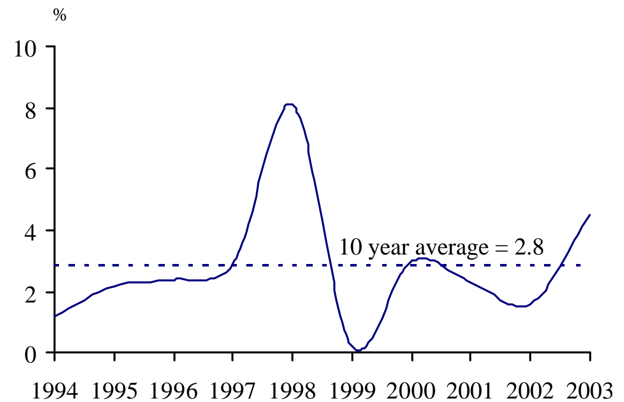
Inflation is the general increase in prices of goods and services. As prices go up, the same amount of money buys fewer goods and services. The rate at which money loses its value depends on the rate of inflation. According to the International Monetary Fund, there are three levels of inflation: low-to-moderate, galloping and hyperinflation.

Low-to-moderate inflation is when the prices of goods and services rise slowly over time. As a result, people are more willing to save their money because the value of their savings is not eroded by high inflation. At the same time, businesses prefer to enter into long-term contracts because they do not expect prices to rise quickly in the future.

Fiji experiences low-to-moderate inflation. (See graph). Since around 60 percent of goods and services are imported, our domestic prices are affected directly or indirectly through changes in the prices of our imports. Fiji's low inflation environment is supported by two factors. First, our fixed exchange rate arrangement helps keep the value of our currency stable. Second, our major trading partners have been very successful in keeping their inflation low.

As the name suggests, galloping inflation is when prices rise at double or triple digit rates such as 30 percent or 100 percent per year. As a result, money loses its value at a rapid rate. This level of inflation is obviously not good for the economy. In view of expected price increases, people will buy goods and services before prices rise again. Hence, they will save less. For example, if the prevailing inflation rate is 30 percent, a one-year fixed deposit with an interest rate of 10 percent will yield a negative real return of 20 percent. Businesses will hesitate to engage in long-term contracts because prices are changing rapidly. Investors will not make investments that yield returns that are below the inflation rate.

Inflation in Fiji



Source: Bureau of Statistics

A more extreme case of increase in prices is known as hyperinflation. At this level, inflation stands at the rate of a thousand, a million or even a billion percent per year. Prices can be rising even during the day. Hyperinflation is disastrous to an economy. Money basically becomes worthless due to severe increase in prices. Consumers thus engage in spending sprees. This puts more pressure on prices of goods and services pushing inflation further upwards.

Hyperinflation was experienced by a number of developing countries, such as Argentina, Brazil and Peru in the decade from 1989 to 1999. There are many causes of hyperinflation. The most common one is the printing of money to finance excessive government deficits. This leads to a lot of currency in circulation, which creates more demand for goods and services causing prices to rise at a rapid rate.

The effects of high inflation on the economy are well known. It destroys economic growth. It erodes the value of money and other assets. It discourages investments. It increases the

uncertainty of doing businesses. In addition, the poorer section of the community suffers more when inflation is rampant because they cannot afford to protect their incomes.

Countries that have been successful in containing inflation have recorded good growth performances for a longer period of time. It is, therefore, important to keep inflation low and stable. The global benchmark for low inflation is around 3 percent. The world performance against inflation has been much better in the last decade with the eradication of hyperinflation and many big countries enjoying low inflation.

The responsibility of keeping inflation low and stable normally falls on central banks. There are several instruments that central banks use to avoid inflation depending on the circumstances of individual countries.

The Reserve Bank of Fiji achieves its prime objective of price stability by influencing the short-term interest rates in the market, which in time, bring about changes to longer term interest rates like the commercial banks lending rates.

These changes in interest rates will influence the decisions of investors to invest; of people to spend or save; and of businesses to expand.

All these will ultimately lead to a change in the total spending in the economy, which will tend to affect prices. For example, if the economy is growing too fast, then inflation is likely to increase.

The central bank steps in and raises interest rates to discourage spending, slowdown the tempo of growth and avoid a significant rise in inflation.

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